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In the Supreme Court of the United States

OCTOBER TERM, 1950

No. 533

SOKOL BROTHERS FURNITURE COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT

OPINIONS BELOW

The memorandum opinion of the Tax Court (R. 87-95) is not reported. The opinion of the Court of Appeals (R. 108-114) is reported at 185 F. 2d 222; its opinion on rehearing (R. 121) is reported at 185 F. 2d 677.

JURISDICTION

The judgment of the Court of Appeals (R. 114) was entered on November 22, 1950. A petition for rehearing was filed by the taxpayer on December 5, 1950 (R. 115-120), and was denied on December

27, 1950 (R. 121-122). The petition for a writ of certiorari was filed on February 5, 1951. The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254.

QUESTION PRESENTED

Taxpayers which, for income tax purposes, account for income from installment sales on the installment method of accounting were given an election under Section 736 (a), Internal Revenue Code, to account for such income on the accrual method of accounting for purposes of the excess profits tax. Applicable Treasury Regulations provide that a taxpayer exercising the election shall compute income on the accrual basis for the excess profits tax, whether the tax is computed under Section 710 (a)(1)(A) or under Section 710 (a)(1)(B), Internal Revenue Code.

The question is whether the Court of Appeals was correct in holding that the taxpayer, which had exercised the election to use the accrual method for excess profits tax purposes, was required to use that method in accounting for income with respect to the computation of the tax under Section 710 (a)(1)(B), and in upholding the Treasury Regulations.

STATUTE AND REGULATIONS INVOLVED

The applicable provisions of the statute and Regulations are set forth in the Appendix, *infra*, pp. 9-20.

STATEMENT

The case was submitted to the Tax Court on a written stipulation of facts which was adopted by the Tax Court as its findings. (R. 88.) The material facts may be summarized as follows:

The taxpayer was organized as a corporation under the laws of Alabama and maintained its principal office at Birmingham, Alabama. It was dissolved in 1947, but, under Alabama law, it remains in existence for five years for the purpose of winding up its affairs. Its tax returns for the period in controversy were filed with the Collector at Birmingham, Alabama. (R. 88.)

During the taxable period, the taxpayer was engaged in the retail business of selling clothing and furniture, its sales being largely on the installment plan. Its net income from such sales, for income and surtax purposes, was computed on the installment basis pursuant to the provisions of Section 44(a), Internal Revenue Code. (R. 88-89.)

For purposes of the excess profits tax during the years in controversy, pursuant to the provisions of Section 736 (a), Internal Revenue Code, (*infra*, pp. 14-16), the taxpayer exercised an election to compute its income from installment sales on the accrual basis of accounting. It fulfilled the requirements of the statute and established its eligibility to compute its income from such sales on the accrual basis for excess profits tax purposes. (R. 89).

The tax on excess profits is the lesser amount of:—95 percent of adjusted excess profits net income (Section 710 (a)(1)(A), Internal Revenue Code) or an amount which, when added to the taxes imposed by Chapter 1, equals 80 percent of the corporation surtax net income, computed under Section 15, but without the credit provided in Section 26(e) (Section 710 (a)(1)(B), Internal Revenue Code). (Appendix, *infra*, pp. 13-14.) In calculating the tax under Section 710 (a)(1)(B) for the years 1944 and 1945, the taxpayer computed its corporation surtax net income, but without the Section 26(e) credit, by accounting for its installment income on the installment method of accounting. The Commissioner determined deficiencies in excess profits tax for those years arising, in part, from his determination that the corporation surtax net income should have been computed by accounting for income from installment sales on the accrual method, pursuant to the election exercised by the taxpayer under Code Section 736 (a) and as required by the applicable Treasury Regulations in such cases. (R. 92.) The Tax Court upheld the Commissioner's deficiency determination in this respect (R. 94-95), and the Court of Appeals affirmed (R. 108-114).

DISCUSSION

This case involves a taxpayer which, for income tax purposes, regularly reports income from installment sales on the installment method of ac-

counting, and which, under Section 736 (a), Internal Revenue Code (Appendix, *infra,* pp. 14-16), elected to account for such income on the accrual method of accounting for purposes of the excess profits tax. The court below held that a taxpayer exercising this election must use the accrual method in accounting for such income when ascertaining the amount of its "corporation surtax net income, computed under section 15," for the purpose of the excess profits tax as determined under Section 710 (a)(1)(B), Internal Revenue Code (Appendix, *infra,* p. 13). The court below, as had the Tax Court, thus upheld the specific provisions to this effect embodied in Section 35.736(a)-3, Treasury Regulations 112 (Appendix, *infra,* p. 16 *ff.*).

Basalt Rock Co. v. *Commissioner,* 180 F. 2d 281 (C.A. 9th), certiorari denied, 339 U.S. 966, involved the parallel provisions of Section 736 (b), Internal Revenue Code, which, in the case of a taxpayer regularly reporting income on the completed-contract method of accounting, extended an election to use the percentage-of-completion method for purposes of the excess profits tax. The court there, however, held that a taxpayer which exercised the election could continue to use the completed-contract method in ascertaining the amount of its corporation surtax net income for the purpose of the excess profits tax as determined under Section 710 (a)(1)(B). The *Basalt* decision, overruling the Tax Court, struck down the

cognate provisions of Section 35.736 (b)-3, Treasury Regulations 112.

While the precise issue in the two cases was different in that they involved the separate subsections of Code Section 736 and the separate methods of accounting which could be elected under that section for excess profits tax purposes, the divergent views of the two circuits do present a conflict, in principle, on the same ultimate problem, *i.e.,* whether Congress intended that the methods of accounting elected under either subsection of Section 736 should be employed in determining the corporation surtax net income, on which is computed the excess profits tax when the tax is determined under Section 710 (a)(1)(B).

Ordinarily, in such a situation the granting of a petition for a writ of certiorari is not opposed. However, we may note that, except for the divergency of views embodied in the decision below, all other factors bearing on the appropriateness of this Court's granting review of this issue have remained unchanged since the filing and denial of the Commissioner's petition in the *Basalt* case, *supra.* Indeed, in certain respects, the *Basalt* case would appear to have been a stronger situation calling for the intervention of this Court. For the petition in that case (No. 803, October Term, 1949, pp. 12-14) pointed to the invalidation of the Treasury Regulations as being in conflict with the decisions of this Court holding that such Regula-

tions must be upheld except when plainly inconsistent with the statute which they interpret. There was also emphasized the peculiar importance of this matter in the context of that case. Such a conflict and such matters of importance, of course, do not arise under the decision below which correctly upheld the validity of the provisions of the Regulations here involved. Further, the *Basalt* petition, in pointing (pp. 15-16) to the general importance of the tax problem of that case and its effect on pending cases (including the present case which was then pending on review in the court below)—matters of importance which have otherwise remained unchanged—also called attention (p. 16) to the very large amount of excess profits tax liability involved in the *Basalt* case itself.

It should be observed, in passing, that the problem of statutory construction here presented cannot arise under the Excess Profits Tax Act of 1950, Public Law 909, 81st Cong., 2d Sess. While Code Section 455, as added by Section 101 of that Act, affords elections similar to those formerly granted by Code Section 736, the imposition of the present excess profits tax under Code Section 430 (a)(1) and (2) differs in method from former Section 710 (a)(1)(A) and (B), the present tax in all respects being measured by the amount of "excess profits net income." Consequently, the same system of accounting would be uniformly followed

in all excess profits tax computations. As it affects the narrow problem of this case, it should be mentioned that there is no indication in the Committee Reports that this was a change in substance over prior law or that Congress believed that the court below was wrong in its interpretation of the former statutes. S. Rep. No. 2679, 81st Cong., 2d Sess., pp. 4-5; H. Conference Rep. No. 3231, 81st Cong., 2d Sess., p. 11.

Although certiorari was denied in *Basalt,* in which we believe more impelling circumstances were present, it is recognized that, unlike the situation as it existed when the *Basalt* petition was filed, there are now conflicting decisions on this narrow tax problem. The Court may feel that this difference is, by itself, sufficient to warrant granting the petition in this case despite the denial of the petition filed on behalf of the Commissioner in the *Basalt* case.

Respectfully submitted,

PHILIP B. PERLMAN,
Solicitor General.

MARCH, 1951.

APPENDIX

Internal Revenue Code:

SEC. 13 [As amended by Section 201 of the Revenue Act of 1939, c. 247, 53 Stat. 862]. TAX ON CORPORATIONS IN GENERAL.

(a) *Definitions.—For the purposes of this chapter—*

(1) *Adjusted Net Income.*—The term "adjusted net income" means the net income minus the credit provided in section 26 (a), relating to interest on certain obligations of the United States and Government corporations.

* * * * *

(2) [As amended by Section 105 (a)(1) of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Normal-Tax Net Income.*—The term "normal-tax net income" means the adjusted net income minus the credit for income subject to the tax imposed by Subchapter E of Chapter 2 provided in section 26 (e) and minus the credit for dividends received provided in section 26(b).

* * * * *

[26 U. S. C. 1946 ed., Sec. 13]

SEC. 15 [As amended by Section 105 (b) of the Revenue Act of 1942, *supra*]. SURTAX ON CORPORATIONS.

(a) *Corporation Surtax Net Income.*—For the purposes of this chapter, the term "cor-

poration surtax net income" means the net income minus the credit for income subject to the tax imposed by Subchapter E of Chapter 2 provided in section 26 (e) and minus the credit for dividends received provided in section 26 (b) (computed by limiting such credit to 85 per centum of the net income reduced by the credit for income subject to the tax imposed by Subchapter E of Chapter 2 in lieu of 85 per centum of the adjusted net income so reduced), and minus, in the case of a public utility, the credit for dividends paid on its preferred stock provided in section 26 (h). For the purposes of this subsection dividends received on the preferred stock of a public utility shall be disregarded in computing the credit for dividends received provided in section 26 (b).

* * * * *

[26 U. S. C. 1946 ed., Sec. 15]

SEC. 21. NET INCOME.

(a) *Definition.*—"Net income" means the gross income computed under section 22, less the deductions allowed by section 23.

(b) [As amended by Section 210 (a) of the Revenue Act of 1939, *supra*] *Cross References.*—For definition of "adjusted net income" and "normal-tax net income", see section 13.

[26 U. S. C. 1946 ed., Sec. 21]

SEC. 26. CREDITS OF CORPORATIONS.

In the case of a corporation the following credits

shall be allowed to the extent provided in the various sections imposing tax—

(a) *Interest on Obligations of the United States and its Instrumentalities.*—The amount received as interest upon obligations of the United States or of corporations organized under Act of Congress which is allowed to an individual as a credit for purposes of normal tax by section 25 (a) (1) or (2). * * *

* * * * *

(e) [As amended by Section 105 (d) of the Revenue Act of 1942, *supra,* and Section 202 (c), Revenue Act of 1943, c. 63, 58 Stat. 21] *Income Subject to Excess-Profits Tax.*—In the case of any corporation subject to the tax imposed by Subchapter E of Chapter 2, an amount equal to its adjusted excess-profits net income (as defined in section 710 (b)). In the case of any corporation computing such tax under section 721 (relating to abnormalities in income in the taxable period), section 726 (relating to corporations completing contracts under the Merchant Marine Act of 1936), section 731 (relating to corporations engaged in mining strategic minerals), or section 736 (b) (relating to corporations with income from long-term contracts), the credit shall be the amount of which the tax imposed by such subchapter is 95 per centum. For the purpose of the preceding sentence the term "tax imposed by Subchapter E of Chapter 2" means the tax computed without regard to the limitation provided in section 710 (a)(1)(B) (the 80 per centum limitation), without regard to

the credit provided in section 729 (c) and (d) for foreign taxes paid, and without regard to the adjustments provided in section 734. This subsection shall not apply to any corporation exempt from such tax under section 725 or section 727.

* * * * *

[26 U. S. C. 1946 ed., Sec. 26]

SEC. 44. INSTALLMENT BASIS.

(a) *Dealers in Personal Property.*—Under regulations prescribed by the Commissioner with the approval of the Secretary, a person who regularly sells or otherwise disposes of personal property on the installment plan may return as income therefrom in any taxable year that proportion of the installment payments actually received in that year which the gross profit realized or to be realized when payment is completed, bears to the total contract price.

* * * * *

(c) *Change From Accrual to Installment Basis.*—If a taxpayer entitled to the benefits of subsection (a) elects for any taxable year to report his net income on the installment basis, then in computing his income for the year of change or any subsequent year, amounts actually received during any such year on account of sales or other dispositions of property made in any prior year shall not be excluded.

* * * * *

[26 U. S. C. 1946 ed., Sec. 44]

SEC. 710 [As added by Section 201 of the Second Revenue Act of 1940, c. 757, 54 Stat. 974]. IMPOSITION OF TAX.

(a) [As amended by Section 201(a) of the Revenue Act of 1941, c. 412, 55 Stat. 687, Section 202 of the Revenue Act of 1942, *supra,* and Section 202(a) of the Revenue Act of 1943, *supra*] *Imposition.*—

(1) *General Rule.*—There shall be levied, collected, and paid, for each taxable year, upon the adjusted excess-profits net income, as defined in subsection (b), of every corporation (except a corporation exempt under section 727) a tax equal to whichever of the following amounts is the lesser:

(A) 95 per centum of the adjusted excess-profits net income, or

(B) an amount which when added to the tax imposed for the taxable year under Chapter 1 (other than section 102) equals 80 per centum of the corporation surtax net income, computed under section 15 or Supplement G, as the case may be, but without regard to the credit provided in section 26 (e) (relating to income subject to the tax imposed by this subchapter).

* * * * *

(b) *Definition of Adjusted Excess Profits Net Income.*—As used in this section, the term "adjusted excess profits net income" in the case of any taxable year means the excess prof-

its net income (as defined in section 711) minus the sum of:

* * * * *

[26 U. S. C. 1946 ed., Sec. 710]

SEC. 711 [As added by Section 201, Second Revenue Act of 1940, *supra*]. EXCESS PROFITS NET INCOME.

(a) *Taxable Years Beginning After December 31, 1939.*—The excess profits net income for any taxable year beginning after December 31, 1939, shall be the normal-tax net income, as defined in section 13 (a)(2), for such year except that the following adjustments shall be made:

* * * * *

[26 U. S. C. 1946 ed., Sec. 711]

SEC. 736 [As added by Section 222 (d) of the Revenue Act of 1942, *supra*]. RELIEF FOR INSTALLMENT BASIS TAXPAYERS AND TAXPAYERS WITH INCOME FROM LONG-TERM CONTRACTS.

(a) *Election to Accrue Income.*—In the case of any taxpayer computing income from installment sales under the method provided by section 44 (a), if such taxpayer establishes, in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, that the average volume of credit extended to purchasers on the installment plan in the four taxable years preceding the first taxable year beginning after December 31, 1941, was more than 125 per centum of

the volume of such credit extended to such purchasers in the taxable year, or the average outstanding installment accounts receivable at the end of each of the four taxable years preceding the first taxable year beginning after December 31, 1941, was more than 125 per centum of the amount of such accounts receivable at the end of the taxable year, or if the taxpayer was not in existence for four previous taxable years, the taxable years during which the taxpayer was in existence, in either case including only such years for which the income was computed under the method provided in section 44 (a), it may elect, in its return for the taxable year, for the purposes of the tax imposed by this subchapter, to compute, in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, its income from installment sales on the basis of the taxable period for which such income is accrued, in lieu of the basis provided by section 44 (a). Except as hereinafter provided, such election shall be irrevocable when once made and shall apply also to all subsequent taxable years, and the income from installment sales for each taxable year before the first year with respect to which the election is made but beginning after December 31, 1939, shall be adjusted for the purposes of this subchapter to conform to such election. In making such adjustments, no amount shall be included in computing excess profits net income for any excess profits tax taxable year on account of installment sales made in taxable years beginning before January 1, 1940. If the taxpayer

establishes, in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, that in a taxable year subsequent to the year with respect to which an election has been made under the preceding provisions of this subsection it would not be eligible to elect such accrual method, the taxpayer may in accordance with such regulations elect in its return for such year to abandon such accrual method. Such election shall be irrevocable when once made and shall preclude any further elections under this subsection. For the taxable year for which the latter election is made and subsequent taxable years, income shall be computed in accordance with section 44 (c).

* * * * *

[26 U. S. C. 1946 ed., Sec. 736]

Treasury Regulations 112, promulgated under the Internal Revenue Code:

SEC. 35.736 (a)-3 *Computation of Income on Straight Accrual Basis.*—If the taxpayer has elected under section 736 (a) and section 35.736 (a)-2 to compute for excess profits tax purposes its income from installment sales on the basis of the taxable year for which such income is accrued, in lieu of the basis provided by section 44 (a), the gross income of the taxpayer from installment sales shall be computed upon such accrual basis. Likewise all deductions under section 23 allowable in computing net income and attributable to such sales, shall be computed upon the straight accrual basis. However, no income or deduction (includ-

ing deductions for bad debts) shall be included in the computation of excess profits net income for any excess profits tax taxable year on account of installment sales made in taxable years beginning before January 1, 1940.

* * * * *

If an election is made under section 736 (a) and section 35.736 (a)-2 for an excess profits tax taxable year beginning after December 31, 1941, or for a subsequent taxable year, to compute excess profits net income on the straight accrual basis in lieu of the installment basis, the following rules shall apply with respect to a taxable year beginning after December 31, 1941: The normal tax and surtax determined under Chapter 1 shall be based upon normal tax net income and surtax net income which include income from installment sales computed under the method provided by section 44 (a), and the excess profits tax shall be determined upon the basis of adjusted excess profits net income which shall include income from installment sales computed upon the straight accrual basis as described in this section. The normal tax net income and the corporation surtax net income for the purposes of the normal tax and surtax under Chapter 1 shall be determined by using as the credit under section 26 (e) (relating to income subject to excess profits tax) the amount of adjusted excess profits net income computed by determining income from installment sales upon the straight accrual basis. For the purposes of determining the excess profits tax under section 710 (a)(1)(B), as an amount which when added to the normal tax and surtax for such year equals 80 percent of the

corporation surtax net income computed without regard to the credit under section 26 (e) the corporation surtax net income shall include income from installment sales computed upon the straight accrual basis described in this section, the credit for dividends received used in computing corporation surtax net income shall be limited to 85 percent of the net income which shall include income from installment sales computed upon such straight accrual basis, and the normal tax and surtax shall be the actual normal tax and surtax determined under Chapter 1.

* * * * *

The provisions of this section may be illustrated by the following example:

Example. Corporation I, which came into existence early in 1936, is a retail dealer selling personal property on the installment plan. It computes its income on the calendar year basis under the method provided in section 44 (a). It has established that the average outstanding installment accounts receivable at the end of the years 1938, 1939, 1940, and 1941 is more than 125 percent of the amount of outstanding installment accounts receivable at the end of 1942. It therefore elects under section 736 (a) and section 35.736 (a)-2 to compute its income from installment sales upon the straight accrual basis for the purposes of the excess profits tax for the year 1942; income from such sales for the years 1940 and 1941 must also be computed upon the straight accrual basis. The net income of Corporation I from installment sales computed upon the installment method and

upon the straight accrual basis, the deductions (not including any deduction for excess profits tax) and the amount of income which will not be subject to excess profits tax as a result of the election under section 736 (a) are shown in the following schedule:

Taxable year	Income accrued	Years to which income is realized by collection and reported upon the installment basis							Unrealized income Dec. 31, 1942
		1936	1937	1938	1939	1940	1941	1942	
1936	$200,000	$70,000	$50,000	$50,000	$30,000	.....	.....	.....	.....
1937	300,000	.....	100,000	100,000	50,000	$50,000	.....	.....	.....
1938	350,000	.....	.....	120,000	150,000	50,000	$30,000	.....	.....
1939	400,000	.....	.....	.....	150,000	100,000	100,000	$50,000	.....
1940	450,000	.....	.....	.....	.....	200,000	150,000	100,000	.....
1941	480,000	.....	.....	.....	.....	.....	250,000	200,000	$30,000
1942	540,000	.....	.....	.....	.....	.....	.....	500,000	40,000
Income	2,720,000	70,000	150,000	270,000	380,000	400,000	530,000	850,000	70,000
Deductions	530,000	50,000	60,000	65,000	75,000	90,000	90,000	100,000	.....
Net income	2,190,000	20,000	90,000	205,000	305,000	310,000	440,000	750,000	70,000

	1940	1941	1942	Unrealized income Dec. 31, 1942
Net income from installment sales for taxable years beginning after December 31, 1939, computed upon installment basis	$400,000	$530,000	$850,000	$70,000
Net income from installment sales for taxable years beginning after December 31, 1939, computed upon accrual basis	450,000	480,000	540,000	.....
Increase in excess profits net income caused by change to accrual basis	50,000	.....	.....	.....
Decrease in excess profits net income caused by change to accrual basis	.....	50,000	310,000	70,000

Income subject to excess profits tax upon installment basis (sum of incomes for 1940, 1941, 1942, and income unrealized as of December 31, 1942)	$1,850,000
Income subject to excess profits tax upon accrual basis (sum of incomes for 1940, 1941, and 1942)	1,470,000
Income which is not subject to excess profits tax if election is made under section 736 (a) to compute income from installment sales upon the accrual method	380,000

* * * * *

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